

# Business Combinations – IFRS 3



For many men, the acquisition of wealth does not end their troubles, it only changes them.

- [Lucius Annaeus Seneca](#)

# Lets get some of the basics correct.....



We need to refer to IFRS-3, the basic objectives of which are:-

Recognition and measurement:-

- a) Of the *identifiable assets* acquired, the liabilities assumed and any *non-controlling interest in the acquiree* in the financial statements;
- b) Of the *goodwill acquired in the business* combination or a gain from a bargain purchase; and
- c) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination.



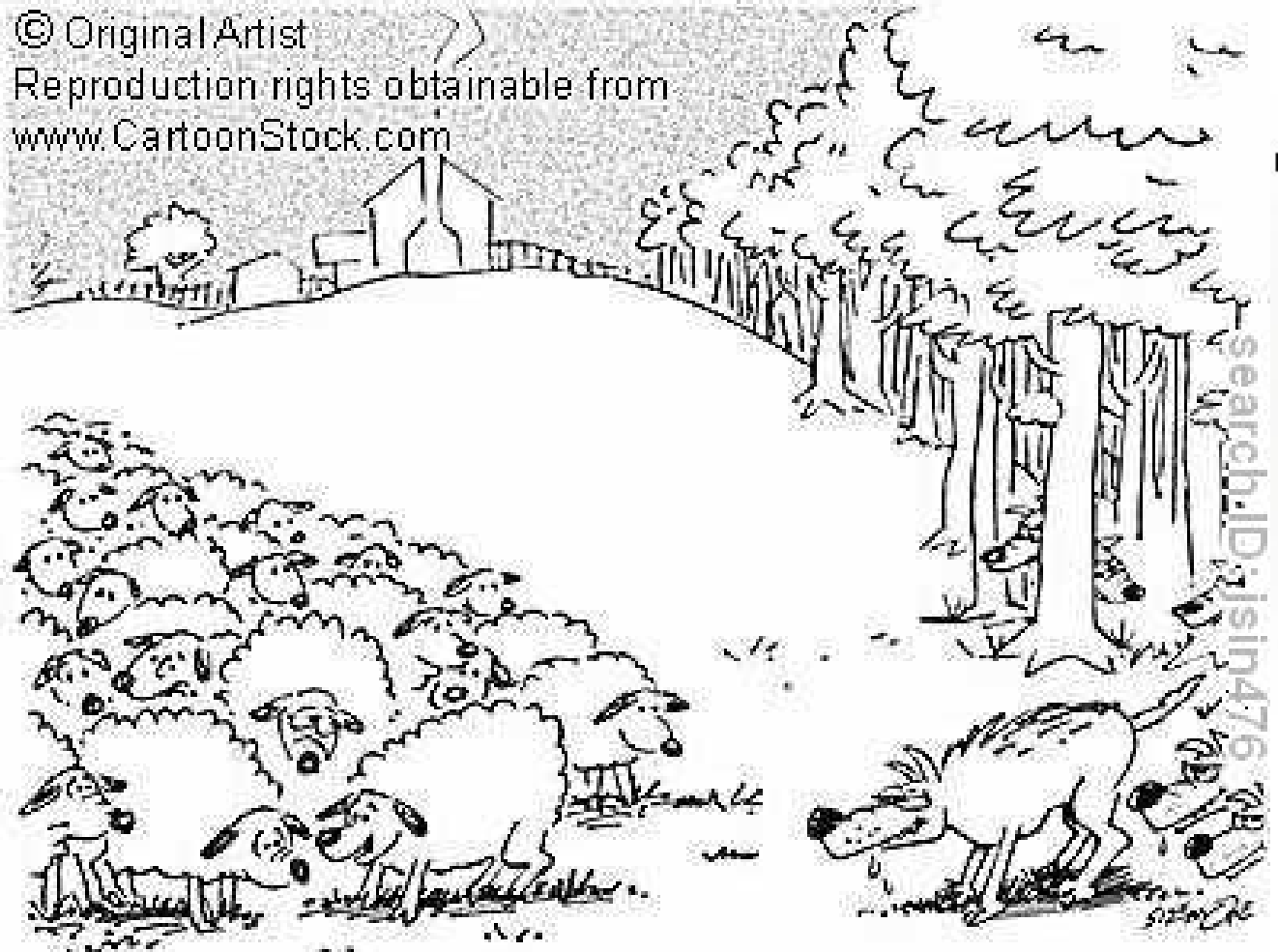
- IFRS – 3 says that all Business Combinations should be accounted for by applying the acquisition method. Thus acquirer should recognise acquiree's:-

- Identifiable assets and
- Liabilities

At the fair value at the acquisition date.



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'Relax. He gave me his word this will be a merger of equals.'

CA Sandesh Mundra  
[Sandesh.mundra@smaca.in](mailto:Sandesh.mundra@smaca.in)

# Issues that arise are?

- What constitutes control?
- What is control?
- Factors influencing control!
- Control or no control? That is the question!
- Control is defined in IAS 27 as:-  
“ Power to govern the operating and financial policies of an entity so as to gain benefits from its activities.”



# Consolidation - Combination



Acquisition



Need for consolidated information



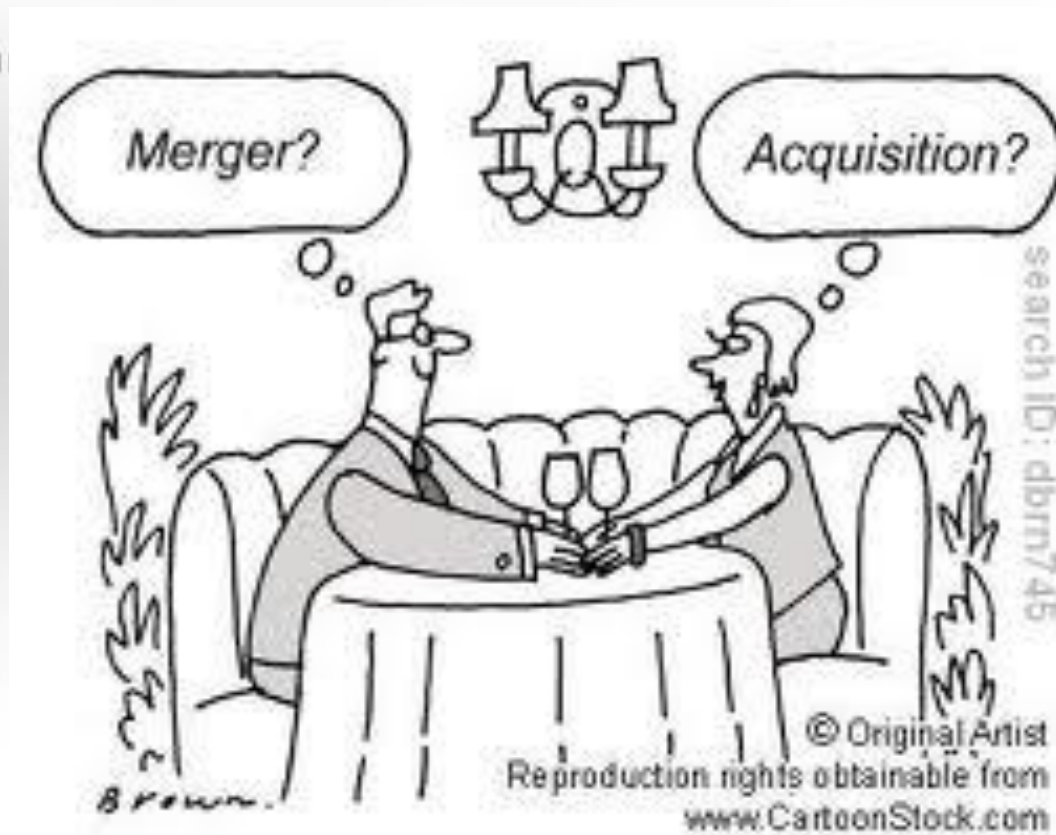
New formation

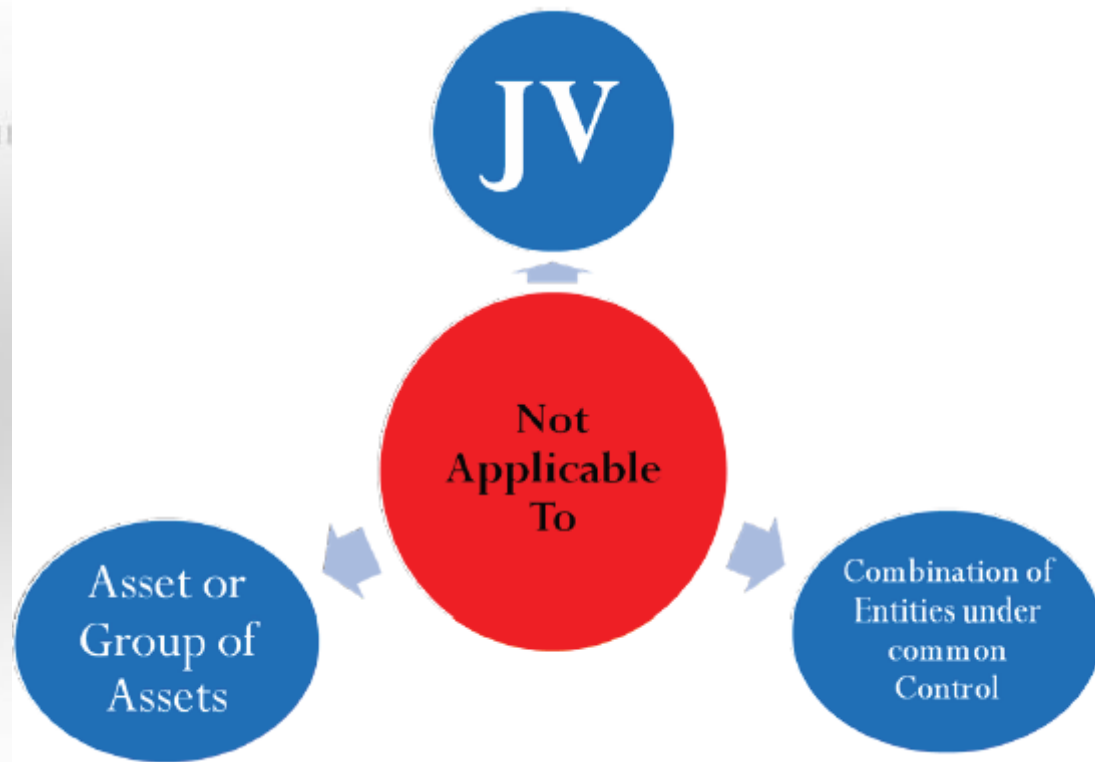


Joint Venture

Hostile take-over







# When is control said to be established:-

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- Equity Shareholding
- Ability to appoint directors to the board
- Potential Voting Rights
- Special Purpose Entities
- Control Agreement
- Defacto Control



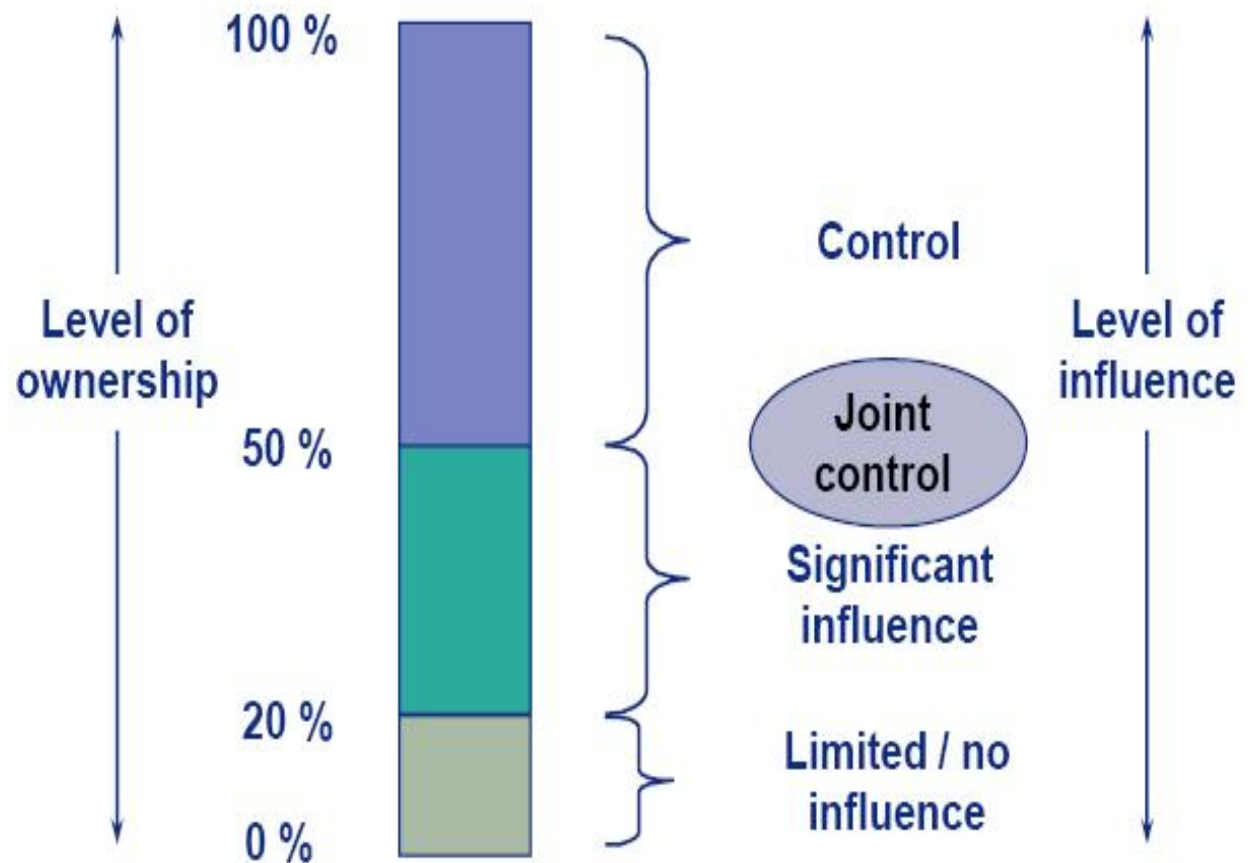


## De facto Control

- Under this model, the power to govern through majority of voting rights, or other legal means does not exist,
- But ability in practise to control i.e. by majority of votes actually cast
- Thus it can lead to consolidation by minority shareholder



# Levels of influence over an investment



# Key Definitions:-



- **Business** - “ *an integrated set of activities and assets conducted and managed for providing....return to investor or economic benefit to stakeholders....generally consists of inputs and processes applied to those inputs , and resulting in outputs that are, or will be used to generate revenues*”.
- *If goodwill is present in a transferred set of activities and assets, the transferred set shall be presumed to be a business.*

**Business Combination** - A transaction or other event in which an acquirer obtains control of one or more businesses. Transactions sometimes referred to as ‘true mergers’ or ‘mergers of equals’ are also business combinations as that term is used in this Accounting Standard.



**Set of  
Activities  
and Assets**

What constitutes Business ?

**Input**



**Process**



**Resulting  
Out  
Generate  
Revenue**



So if Reality Ltd wishes to acquire True Limited, which of the following give rise to business combination:-

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- **It purchases 100% equity of True Ltd**
- **It purchases only the Net assets of True Ltd**
- **It purchases the complete pharmaceutical software division of True Ltd.**
- **It purchases the brand name of True Ltd**
- **It enters into an agreement to govern the financial and operating policies of True Ltd**
- **It enters into a Joint Venture with True Limited**



# Lets take a look at the GAAP Differences

- Under IFRS, business combination has a wider scope.
- IFRS requires that for each business combinaton, the acquirer shall measure any non-controlling interest in the acquiree either at fair value or at the non-controlling interest's proportionate share of the acquiree's identifiable net assets.



Under the existing AS 14, the acquired assets and liabilities are recognised at their existing book values or at fair values under the purchase method (Accounting on basis of Court Order).

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# GAAP differences continued.....

- AS 14 requires that the goodwill arising on amalgamation in the nature of purchase is amortised over a period not exceeding five years.
- IFRS deals with reverse acquisitions whereas the existing AS 14 does not deal with the same.
- As per IFRS, the consideration includes any asset or liability resulting from a contingent consideration arrangement. No guidance in AS 14.

IFRS gives guidance on Preexisting relationships on which AS-14 is silent.



# Goodwill vs Negative Goodwill



## Under Indian GAAP

- Negative Goodwill to be capital reserve

## Under IFRS

- Negative Goodwill to be credited to profit & loss account (Bargain Purchase)

## Under IND-AS

First Carve OUT



# Second Carve Out

- IFRS 3 *Business Combinations* excludes common control business combinations from its scope. However, Ind-AS 103 requires such combinations to be accounted using the pooling of interest method.



- IFRS 3 requires a bargain purchase gain on business combination to be recognized in profit or loss for the period. However, Ind-AS 103 requires the same to be recognized in OCI and accumulated in equity as capital reserve. However, if there is no clear evidence of bargain purchase, companies will recognize the gain directly in equity as capital reserve, without routing the same through OCI.



# What is the cost of a business combination?

- Fair values, at the date of exchange, of assets given,
- liabilities incurred or assumed, and equity instruments issued in exchange for gaining control;
- 



# Costs you can't include!

## Consideration

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- a) Cost of maintaining an acquisitions department
- b) Cost of internal staff who work on the deal
- c) Cost of investigation
- d) Incentives to of potential targets employees to remain with company post acquisition
- e) Issue costs for debt or equity
- f) Direct costs related to acquisition like consultant fees, rating fee eTrue Ltd.

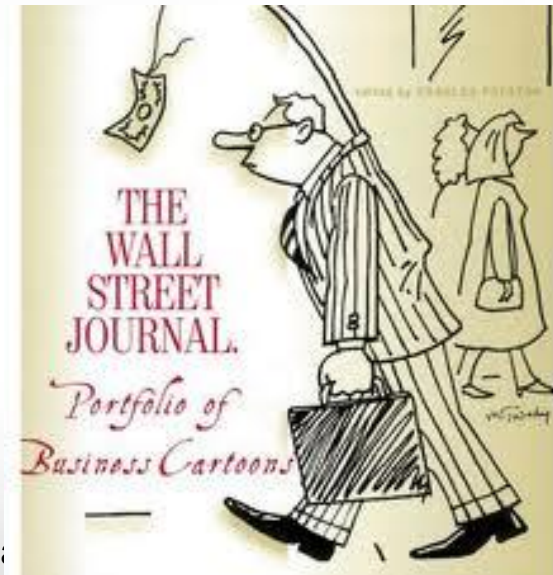


# Fair value everything!

- Identifiable assets, liabilities and contingent liabilities recognised at fair value (FV).

*FV is “amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”.*

- Acquirer’s intentions are not relevant!
- Difference between cost and net FV of identifiable assets, liabilities and contingent liabilities is goodwill.
- Goodwill represents future economic benefits not identified / separately recognised.



- Acquirer's intentions are not relevant

Eg. When Aditya Birla Group acquired




# Fair Values to be considered

- - Equity Instruments > Published Price at date of exchange except under rare circumstances
- - Financial instruments > Market values
- - Receivables > Present values net of allowances
- - Inventories FG > NRV less reasonable profits
- - Inventories RM > Replacement Cost
- - Land and Building > Market Value
- - Plant and Machinery > Market Value
- - Taxes > From acquirers perspective
- - Notes payable, liabilities > Present Values
- - Contingent Liabilities > Third party ...expectation of possible cash flows



## Exceptions to FV @ A



Recognition	Recognition & Measurement
<p>Contingent Liabilities Even if Outflow is not probable .</p> 	<p>1. Income Taxes as per IAS 12</p> <p>2. Employee Benefits – IAS 19</p> <p>3. Indemnification Assets</p>



# Recognition criteria for intangible assets acquired in a business combination

- Is it identifiable as it arises from contractual or other legal rights or separable from the entity ( can be sold, transferred ,licensed or exchanged)
  - Can the cost of the asset be measured reliably (Highly probable, except in rare circumstances)
- Recognise the asset separately from goodwill
- Is it a resource (future benefits) without physical substance controlled by the entity?
- Ex – Customer Lists – Non-Contractual,
- Orders – Contractual,
- Customer Relationships – Non Contractual, Internet Domain - Contractual



# Allocation of cost

- Identify which items would be recognised separately from goodwill under IFRS 3, and why (i.e., due to satisfying the specified recognition criteria in IFRS 3 and IAS 38).
- Satisfies the definition of an intangible asset and fair value can be reliably measured. Therefore recognised separately from goodwill.
  - (a) Customer contracts
  - (b) Internet domain names
  - (c) Customer database
  - (d) Brand name
  - (e) In-process R&D
  - (f) Lease agreement
  - (g) Trademarks, trade names, service
  - (h) Order backlog
  - (l) Licenses, royalties, agreements, rights, contracts



# Allocation of cost (cont'd)

- IFRS 3 requires all contingent liabilities of the acquiree to be recognised at their fair values (provided that fair value can be reliably measured).
- Recognition even if the amount is not payable as per the relevant standard on Contingent Liability



# Exercise – Fair Valuation

- Entity C has acquired its principal competitor, entity D. Entity C's management has explained that its motivation for the acquisition was to acquire market share by taking its rival's brand out of the market. Management has, therefore, proposed that the brand be allocated at minimal value since it will be removed from the market shortly after the acquisition.
- How will the Brand be valued ?



# Solution....

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- Management's proposal is not appropriate, the fair value attributed to assets and liabilities is not affected by the intentions of the acquirer. The fair value is what a third party would pay for the assets (or charge to assume liabilities).
- The value of the brand name should be based on the assumption of cash flows from continuing use or sale to a third party. Buying a brand to 'take it out of the market' has a cost associated with it. It is not appropriate to mask this cost by assigning a low fair value to the brand in the purchase price allocation. The value assigned to the brand should be amortised, based on the expected useful life to Entity C, and tested for impairment.



Taking the brand out of the market may result in a post acquisition impairment charge.

# Treatment of Difference between cost and Net Assets

- Excess of Cost => Goodwill
- Excess of Net Asset => Gain taken to P & L in IFRS

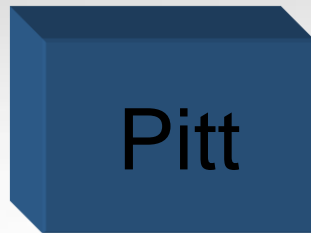
Under IND-AS, we shall take it to Other Comprehensive Income.

- However, before recognising gain the acquirer is required to re-assess the identification and measurement of cost and net assets
- Goodwill, if any, is not amortised but is tested for impairment at least annually, in accordance with IAS 36.



# Illustration of a Purchase Combination

Pitt Corporation acquires the net assets of Seed Company on December 27, 2010.



# Illustration of a Purchase Combination

Book  
Value

Fair  
Value

## Assets

Cash	\$ 50	\$ 50
Net receivables	150	140
Inventories	200	250
Land	50	100
Buildings, net	300	500
Equipment, net	250	350
Patents		50

**Total assets**

**\$1,000**

**\$1,440**

# Illustration of a Purchase Combination

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Book  
Value

Fair  
Value

## Liabilities

Accounts payable

\$ 60

\$ 60

Notes payable

150

135

Other liabilities

40

45

Total liabilities

\$250

\$ 240

Net assets

\$ 50

\$1,200



# Illustration of a Purchase Combination

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## Goodwill

Pitt pays \$400,000 cash and issues 50,000 shares of Pitt Corporation \$10 par common stock with a market value of \$20 per share.

$$50,000 \times \$10 = \$500,000$$



# Illustration of a Purchase Combination

Investment in Seed	1,400,000	
Cash		400,000
Common Stock		500,000
Share Premium		500,000

To record issuance of 50,000 shares of \$10 par common stock plus \$400,000 cash in a purchase business combination with Seed Company



# Illustration of a Purchase Combination

## Debit

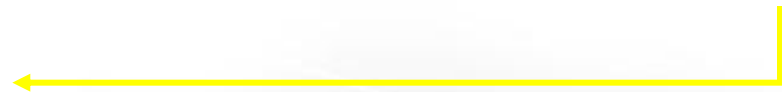
Cash	50
Net receivable	140
Inventories	250
Land	100
Buildings, net	500
Equipment, net	350
Patents	50

**Goodwill 200**

## Credit

Accounts payable	60
Notes payable	135
Other liabilities	45
Investment in Seed Company	1,400

$$\text{\$1640} - 1,440 = 200$$



# Significant changes - goodwill

- Acquired business measured at fair value as a whole
- 100% goodwill recognised
  - Consistent with treatment of other assets
- Goodwill allocated between acquirer and non-controlling interest (was minority interest)
- Allocation of goodwill to acquirer based on:
  - Fair value of acquirer's equity interest LESS
  - Fair value of share of net assets acquired
  - Balance to NCI



# IFRS : Goodwill example

- P acquires 75% (750 000 shares) of S for Rs 7.5cr
- Value of S = Rs 9.7cr
- Fair value of net assets acquired = Rs 8cr

Current requirements AS	
Consideration	7,5
Share of identifiable A (75% 8m)	<u>(6,0)</u>
Goodwill as per IFRS 3	1,5

Current requirements	
Goodwill	1,5
Net assets	8,0
Minority interest	2,0



# IFRS : Goodwill example

## Current requirements AS 21

Goodwill	1,5
Net assets	8,0
Minority interest (MI)	2,0



## IFRS

Goodwill	1,7
Net assets	8,0
Non-controlling interest (NCI)	2,2

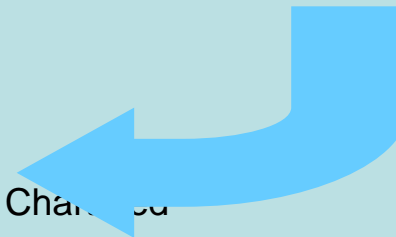
## IFRS

Fair value of S	9,7
Fair value of net assets	<u>(8,0)</u>
Goodwill	1,7



## IFRS - allocate to P

Consideration	7,5
Share of identifiable A+L (75% 8m)	<u>(6,0)</u>
GW allocated to P	1,5
=> Balance to NCI	0,2



# Goodwill – allocation

- Goodwill – allocated to all CGU's, expected to benefit from synergies from the combination
- Goodwill allocation must be completed before the end of the first reporting period beginning after the business combination
- Cash generating unit or group of units to which goodwill is allocated should be tested for impairment during the year in which goodwill was allocated



# Exercise - Acquisition Date

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Entity X acquires 100% of entity Y for cash. The sale agreement specifies that the acquisition date is 10<sup>th</sup> March.

Directors are nominated by entity X and appointed in place of the existing directors on 1 April, the date when all of the conditions in the sale agreement are satisfied. The shares in entity Y are transferred to entity X when the consideration is paid in cash on 15 April.



# Solution...

- Based on the facts given above, the date of acquisition is 1 April, the date from which entity X is able to govern entity Y's financial and operating policies. This is the date on which entity X is able to appoint the directors.
- The consideration in this case is an obligation to make payment at a later date. The consideration is exchanged on 1 April when control of entity Y was transferred to entity X. The payment of cash on 15 April does not affect the acquisition's recognition.
- The date established in the sale agreement is not binding for accounting purposes. The date when control passes to the acquirer will often differ from the date set in the agreement.



# Date of Exchange V/S Acquisition Date

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- Date of exchange is date of each exchange transaction whereas acquisition date is date of obtaining control of acquiree.
- Valuation is based on date of exchange but all the components that existed at the date of acquisition are recognised.



# Exercise

- Entity A acquired 80% of entity B for C250 in cash.
- Entity B's net assets had carrying value at the date of acquisition as C100. Entity A obtained an independent appraisal of the property, plant and equipment at the acquisition date and restated the assets at fair value.
- Entity A also determined that the carrying amount of the current assets and liabilities was not materially different from fair value.
- The fair value of Entity B's net assets at the date of acquisition, after the adjustment to the property, plant and equipment, was C200.



# Solution.....

In Entity A's consolidated financial statements:-

- The minority interest in entity B will be C40 (calculated as 20% of C200 (the fair value of entity B's net assets)).
- Goodwill will be C90 (calculated as C250 (consideration given) - C200 (the fair value of entity B's net assets) x 80%).
- The carrying value of entity B's net assets will be C200.



# Additional Matters

- Treatment of Cost Contingent on Future Events
  - Included in cost at acquisition date if the adjustment is probable and can be measured reliably
  - Where criteria are met later, the additional consideration is treated as an adjustment to the cost of combination
- May include assets/liabilities not previously in books of acquiree, e.g.: - Deferred tax - Intangible assets



# Adjustments to Acquisition Date Values...

- Suppose that AC acquires True Ltd on 30 September 20X7.
- AC seeks an independent valuation for an item of property, plant and equipment acquired in the combination, and the valuation was not complete by the time AC approved for issue its financial statements for the year ended 31 December 20X7.
- In its 20X7 annual financial statements, AC recognised a provisional fair value for the asset of Rs 30,000.
- At the acquisition date, the item of property, plant and equipment had a remaining useful life of five years.
- Five months after the acquisition date, AC received the independent valuation, which estimated the asset's acquisition date fair value as Rs 40,000



# Continued....

- In its financial statements for the year ended 31 December 20X8, AC retrospectively adjusts the 20X7 prior year information as follows:
- (a) The carrying amount of property, plant and equipment as of 31 December 20X7 is increased by Rs 9,500. That adjustment is measured as the fair value adjustment at the acquisition date of Rs 10,000 less the additional depreciation that would have been recognised if the asset's fair value at the acquisition date had been recognised from that date (Rs 500 for three months' depreciation).
- (b) The carrying amount of goodwill as of 31 December 20X7 is decreased by Rs 10,000.
- (c) Depreciation expense for 20X7 is increased by Rs 500.



# Pre-existing Relationships

- Reality purchases electronic software from True Ltd under a five-year supply contract at fixed rates.
- Currently, the fixed rates are higher than the rates at which Reality could purchase similar software from another supplier.
- The supply contract allows Reality to terminate the contract before the end of the initial five-year term but only by paying a Rs 6 million penalty.
- With three years remaining under the supply contract, Reality pays Rs 50 million to acquire True Ltd, which is the fair value of True Ltd based on what other market participants would be willing to pay.



# Continued.....

- Included in the total fair value of True Ltd is Rs 8 million related to the fair value of the supply contract with Reality. The Rs 8 million represents a Rs 3 million component that is 'at market' .
- In this example, Reality calculates a loss of Rs 5 million (the lesser of the Rs 6 million stated settlement amount and the amount by which the contract is unfavourable to the acquirer) separately from the business combination. The Rs 3 million 'at-market' component of the contract is part of goodwill.



# Contingent payments to employees

- TC appointed a candidate as its new CEO under a ten-year contract. The contract required TC to pay the candidate Rs 5 million if TC is acquired before the contract expires. AC acquires TC eight years later. The CEO was still employed at the acquisition date and will receive the additional payment under the existing contract.
- In this example, TC entered into the employment agreement before the negotiations of the combination began, and the purpose of the agreement was to obtain the services of CEO. Thus, there is no evidence that the agreement was arranged primarily to provide benefits to AC or the combined entity. Therefore, the liability to pay Rs 5 million is included in the application of the acquisition method.



# Continued....

- In other circumstances, TC might enter into a similar agreement with CEO at the suggestion of AC during the negotiations for the business combination. If so, the primary purpose of the agreement might be to provide severance pay to CEO, and the agreement may primarily benefit AC or the combined entity rather than TC or its former owners. In that situation, AC accounts for the liability to pay CEO in its post-combination financial statements separately from application of the acquisition method.



# Reverse Acquisition

- A reverse acquisition occurs when the entity that issues securities (the legal acquirer) is identified as the acquiree for accounting purposes .
- The entity whose equity interests are acquired (the legal acquiree) must be the acquirer for accounting purposes for the transaction to be considered a reverse acquisition.



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- For example, reverse acquisitions sometimes occur when a private operating entity wants to become a public entity but does not want to register its equity shares. To accomplish that, the private entity will arrange for a public entity to acquire its equity interests in exchange for the equity interests of the public entity.
  - In this example, the public entity is the **legal acquirer because it issued its equity interests, and the private entity is the legal acquiree because its equity interests were acquired.**



# Key points to take away

- Understand the economics of the transaction before looking at the accounting.
- Consider whether you have an asset acquisition or a business combination.
- Control is a much broader concept than % equity ownership.
- Cost: determine what is a cost of the business combination and what is a post-acquisition cost.



# Disclosures



- Information that enable users of its financial statements to evaluate the nature and financial effect of the business Combination
- For each business combination
  - Names and description
  - Acquisition Date
  - Percentage of Voting Instruments Acquired
  - Cost of Business Combinations and its components, including Equity – Number, Basis of FV; published or why not published price used.
  - Operations intended to be disposed off
  - At acquisition date, amounts for each class of assets & liabilities
  - Gain, if any and the line item
  - Factors contributing to recognition of Goodwill and description of each intangible asset that was not recognised and explanation why not recognised.
  - Profit or Loss since the acquisition date



# Disclosures (Continued)

- For immaterial combinations disclosure may be aggregated:-
- Fact of provisional determination of values
- Revenue & Profit or loss of combined entity as though business combinations were effected at the beginning of the period.
- Information that enables users of its financial statements to evaluate financial effects of gains and losses, error corrections and other adjustments recognised in current period that relate to business combinations that were effected in current or previous periods.
- Changes in Carrying amount of Goodwill during the period



# Lets now start preparing CFS.....

